

**Letter Report: The Tax Exempt and Government
Entities Division Needs to Improve the Oversight
Process for Referrals and Information Items**

October 2000

Reference Number: 2001-10- 002

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 12, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report - The Tax Exempt and Government Entities
Division Needs to Improve the Oversight Process for Referrals
and Information Items

This report presents the results of our review on the processing of referrals and information items in the Tax Exempt and Government Entities (TE/GE) Division. In summary, we concluded that the TE/GE Division had completed several actions that were designed to improve the quality and timeliness of examinations initiated from referrals and information items. However, further improvements are needed because examination case files did not always include sufficient documentation to assess the reason for initiating an examination.

Our recommendations will increase assurances that procedural controls are being followed by improving the documentation requirements and improving managerial review processes. TE/GE Division management agreed with each of the recommendations presented in the report. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are being sent to the Internal Revenue Service managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have any questions, or your staff may call Maurice S. Moody, Associate Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Objective and Scope

We determined whether procedures for processing information items and referrals in the Tax Exempt and Government Entities Division provided reasonable assurance that examinations were initiated only for business-related purposes.

The objective of this audit was to determine whether exempt organizations received fair and equitable treatment when information was referred to the Internal Revenue Service (IRS). The objective was accomplished by determining whether corrective actions agreed to in the former Office of the Chief Inspector (now Treasury Inspector General for Tax Administration) report titled, *Controls Over the Processing of Exempt Organization Cases at the National Office* (Reference Number 083905, dated June 12, 1998) corrected the reported conditions.

Specifically, we evaluated practices and procedures for processing referrals and information items and analyzed closed examination case files in the Tax Exempt and Government Entities (TE/GE) Division to:

- Determine whether the IRS implemented corrective actions for the case control issues reported in the prior audit report.
- Assess whether the completed actions appropriately corrected the reported conditions.

We also determined whether information items forwarded to the TE/GE Division from the Legislative Affairs function were appropriately evaluated for audit consideration.

We conducted our audit in accordance with *Government Auditing Standards*. The audit was initiated as part of our review regarding the reliability of controls on the Exempt Organization Returns Inventory Classification System. It was performed in the National Headquarters, the Baltimore Key District Office (KDO),¹ and the Brooklyn KDO between January and June 2000.

¹ In April 2000, the TE/GE Division replaced the KDOs with Area Sites.

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Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List. Also, management's complete response is included in Appendix III.

Background

In recent years, there have been several media reports critical of the examination selection process for exempt organizations. The concerns raised in the articles included allegations that specific organizations are targeted for political purposes and that the process is either improperly selecting taxpayers or otherwise susceptible to manipulation by third parties.

The results of a prior audit required the TE/GE Division to perform several actions designed to improve case selection practices.

A prior audit by the former Office of the Chief Inspector (now the Treasury Inspector General for Tax Administration) determined whether outside political influences affected case selection practices within the IRS Employee Plans and Exempt Organizations function.² As a result of that audit, the TE/GE Division initiated several actions that were designed to improve the controls over case selection practices.

Referrals and information items sent to the TE/GE Division are evaluated by the Review and Classification staff and can originate both internally and externally. Correspondence from the Congress and the White House is sent to the TE/GE Division through the Legislative Affairs function. Specialists in the TE/GE Division research reported allegations and determine whether an examination should be performed. The results of these evaluations are captured on a classification sheet.

A panel of three employees evaluates high-profile cases, while only specialists evaluate less sensitive cases. If the evaluation determines that a referral or information item does not warrant an examination, procedures

² In December 1999, the TE/GE Division was designated to replace the Employee Plans and Exempt Organizations function.

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require the Review and Classification function to retain the referral or information item for 3 years.

Results

A review of examination case files found no evidence that organizations were inappropriately targeted for examination.

The TE/GE Division has progressed in its implementation of controls associated with the processing of referrals and information items in the TE/GE Examination function. The prior audit report included recommendations to establish time standards for processing referrals and information items, as well as new procedures to improve management controls. Since the issuance of the audit report in June 1998, the IRS has completed several actions that were designed to improve the quality and timeliness of examinations initiated from referrals and information items. Further improvements are needed because examination case files did not always include sufficient documentation to assess the reason for initiating an examination. While this lack of documentation prevented us from making a complete determination, our review of the available data for a sample of 32 of 158 referrals from the Legislative Affairs function and 51 of 839 examination case files within the TE/GE Division identified no evidence that organizations were inappropriately targeted for examination.

The corrective actions from the prior audit required the TE/GE Division to make several procedural changes and reaffirmed the importance of following existing procedures. While some procedures are still in the draft stages and have not been finalized, managers in the TE/GE Division have instructed employees to follow the draft procedures. Specifically, the TE/GE Division completed the following actions:

- Time standards were established for the prompt processing and retention of referral and information item examinations. The standards now require classifiers to evaluate the audit potential of information items within 90 days of receipt in the Review and Classification function. In addition, a

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3-year retention period was established for maintaining closed referral and information item examination case files.

- Actions were taken to better control referrals and information items initially received in the National Headquarters and forwarded to the KDOs for processing. In addition, inventory controls were established to improve the ability of the TE/GE Division to manage the processing of examinations.
- Existing procedures that required employees to record the Audit Information Management System (AIMS)³ source code that best describes the originator or the document initiating the request were re-emphasized in an employee memorandum.

Information item requests forwarded from the Legislative Affairs function were appropriately controlled and timely processed.

In addition to completing actions from the prior audit report, the TE/GE Division has established adequate controls over the processing of information items received by the Legislative Affairs function. We reviewed 32 potential information item requests that were forwarded to the TE/GE Division from the Legislative Affairs function between January and December 1999 and concluded that each was appropriately controlled and timely processed.

However, while appropriate procedural controls have been established for processing information items and referrals, the TE/GE Division has not incorporated the necessary oversight processes to ensure that procedures are being followed.

Improving Oversight Processes Would Reduce the Risk of Initiating Examinations For Other Than Legitimate Business Purposes

Case files did not always contain sufficient evidence to assess the reason for initiating the examination or for

³ The AIMS is a master file of cases under Examination jurisdiction.

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closing the case file without an examination after it was sent from the Review and Classification units. Also, the Examination case files did not contain sufficient evidence to assess whether the Review and Classification Unit processed the referrals and information items within the prescribed time frames. Ensuring that examinations are started timely and that the reasons for initiating the examination are included in the case files can improve customer service and would reduce the risk that organizations are being targeted for other than legitimate business purposes.

Audit evidence that should be in the Examination case files includes a copy of the tax return, the closing record from the AIMS, and the case chronology record. Classification sheets capture information on the source of the referral or information item as well as critical dates that are needed to evaluate the timely processing of examination cases. Once a case is established on the AIMS, the source code that best describes the originator or actual source of the information item should be recorded on the AIMS record. In addition, significant case actions should be documented in the case chronology.

We reviewed 51 case files that were closed from the Base Inventory Master File⁴ between January and December 1999. Each of the 51 case files reviewed included actions that were initiated after the IRS' corrective actions were completed; 21 were closed with a disposal code indicating the tax return was examined, and 30 were closed with a disposal code indicating the tax return was not examined.

The reason for initiating the examination was not always sufficiently documented in the closed Examination case file.

Our review of the 21 returns that were fully examined indicated that most cases did not contain sufficient documentation of the reason for initiating the examination, and the few that did have sufficient supporting documentation were inconsistent with the information on the AIMS record. For example, 16 of

⁴ The Base Inventory Master File is a historical database comprised of all open and closed AIMS records for the TE/GE Division.

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the 21 case files did not contain classification sheets or other supporting documentation needed to assess the reason for initiating the examination.

While the remaining five case files included the classification sheets or other source documents that could be used to support the source code reflected on the AIMS record, each of the AIMS codes was inconsistent with the supporting documentation. For example, one case showed a source code 60 on the AIMS record, reflecting that the examination was initiated as a result of an information report, when, in fact, the examination was initiated as a result of a referral from a state agency.

Our review of the 30 case files that were closed with a non-examined disposal code concluded that 19 cases did not include an explanation for closing the return without an examination. In addition, eight of the case files did not have the action stamped on the face of the returns or the approval of the Group Manager documented in the Examination file. If information items sent to the groups are closed without an examination, the survey action should be stamped on the face of the return and the closing action approved by the Group Manager. Managers are not required to document the reasons for closing a referral or information item without an examination. However, a system of internal controls should include requirements to document the reason for closing a referral or information item without an examination.

These conditions could have been prevented if oversight processes provided better assurances that documentation standards were being met. Group Managers in the TE/GE Division review and approve each completed examination. Examination case files may also be reviewed as part of the Tax Exempt Quality Measurement System (TEQMS). When approving completed examinations, Group Managers use the TEQMS criteria as well as the employee's job elements and standards. Referrals and information items that are forwarded to the groups but are closed without an examination are not included in the TEQMS process.

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The TEQMS evaluates the examination based on eight general quality standards in conjunction with several elements that describe the criteria for each general standard. While the criteria are often very specific, we did not identify any elements that specifically addressed whether the source of the examination was appropriately documented in the Examination case file.

Recommendations

We recommend the TE/GE Division perform the following:

1. Eliminate procedures that allow Group Managers discretion in documenting the reasons for closing a case file without an examination and require them to adequately document the reasons for closing the case without an examination.
2. Re-emphasize requirements to include documentation on the time frames for initiating examinations and the reasons for audit selection in the Examination case files and re-emphasize requirements to record the source of the referral or information item on the AIMS.
3. Revise the TEQMS Case Review Input Form to include elements for documenting the source of referrals on completed examinations.
4. Perform a mandatory review on all non-examined referrals and information items to provide further assurances that all of the appropriate approvals and written explanations are documented in the Examination case file.

Management's Response: The TE/GE Division will adopt procedures, which will require group managers to document the reason for closing cases without an examination. The Director, Exempt Organizations Examinations, will issue instructions which require case files to include clear explanations of the reasons for selecting referrals or information items for examination or for closing them without an examination.

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The TE/GE Division will also develop procedures that will require both examined and unexamined information items to be closed through the Exempt Organizations' centralized classification unit. All information items will be examined to ensure that case files are adequately documented with a referral sheet that will capture the reason a referral or information item was selected for examination, the source of the referral or information item, as well as all relevant dates. When an information item is closed without an examination, the classification unit will ensure that the reason for closing the case is adequately documented and that the decision to close the case is stamped across the face of the return.

Conclusion

The TE/GE Division completed several actions to improve control over the processing of information items, which has been scrutinized in several media reports over the past few years. While new procedural controls for processing referrals and information items have been established, the TE/GE Division needs better oversight processes to ensure that the procedures are being followed.

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the Oversight Process for Referrals and Information Items**

Appendix I

Major Contributors to This Report

Maurice S. Moody, Associate Inspector General for Audit (Headquarters Operations and
Exempt Organizations Programs)

Joseph Edwards, Director

James V. Westcott, Audit Manager

Gary D. Pressley, Senior Auditor

Steven R. Bohrer, Auditor

Carolyn D. Miller, Auditor

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Appendix II

Report Distribution List

Deputy Commissioner Operations C:DO
Commissioner, Tax Exempt and Government Entities Division T
Deputy Commissioner, Tax Exempt and Government Entities Division T
Director, Exempt Organizations T:EO
Executive Assistant for the Director, Exempt Organizations T:EO
National Taxpayer Advocate TA
Chief Counsel CC
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis M:O
Office of Management Controls CFO:A:M

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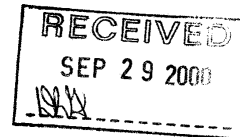
Appendix III

Management's Response to the Draft Letter Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 29, 2000



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Charles O. Rossotti
Charles O. Rossotti
Commissioner of Internal Revenue

SUBJECT:

Response to Draft Audit Report – The Tax Exempt and Government Entities Division Needs to Improve the Oversight Process for Referrals and Information Items

Thank you for the opportunity to respond to your draft report entitled "The Tax Exempt and Government Entities Division Needs to Improve the Oversight Process for Referrals and Information Items." We appreciate your observations about the way the Tax Exempt and Government Entities Division (TE/GE) has implemented corrective actions agreed to in the report of the former Office of the Chief Inspector entitled "Controls Over the Processing of Exempt Organization Cases at the National Office" (Reference number 083905, dated June 12, 1998).

We are gratified that your draft report, like every other report which has inquired into the matter, found no evidence of outside political influences affecting case selection practices within TE/GE, or its predecessor organization, the Employee Plans and Exempt Organizations function.

We also appreciate your finding that TE/GE has established adequate controls over the processing of information items forwarded to TE/GE by the IRS Legislative Affairs function, and your observation that each of 32 potential information item requests forwarded by Legislative Affairs between January and December 1999, was appropriately controlled and timely processed.

Our comments on the specific recommendations in the report are as follows:

IDENTITY OF RECOMMENDATION # 1

Eliminate procedures that allow Group Managers discretion in documenting the reasons for closing a case file without an examination and require them to adequately document the reasons for closing the case without an examination.

ASSESSMENT OF CAUSE(S)

Current procedures do not require group managers to document the reason for closing a case without an examination.

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CORRECTIVE ACTIONS

TE/GE will adopt procedures which will require group managers to document the reason for closing a case without an examination.

IMPLEMENTATION DATE

January 31, 2001.

RESPONSIBLE OFFICIAL(S)

Director, Exempt Organizations Examinations

CORRECTIVE ACTION(S) MONITORING PLAN

A copy of the procedures will be provided to the Director, Exempt Organizations.

IDENTITY OF RECOMMENDATION # 2

Re-emphasize requirements to include documentation on the time frames for initiating examinations and the reasons for audit selection in the Examination case files and re-emphasize requirements to record the source of the referral or information item on the Audit Information Management System (AIMS).

ASSESSMENT OF CAUSES(S)

Case files do not consistently contain dates or other information showing when an information item was classified or an examination was initiated. Case files also do not consistently explain why an information item was either selected for examination or closed without an examination. The AIMS record sometimes does not identify the source of the information item. In other instances, the AIMS record sometimes shows a generic source code when a specific source code would be more accurate.

CORRECTIVE ACTIONS

On August 16, 2000, at a managers meeting, the Director, Exempt Organizations Examinations, informed all Exempt Organizations (EO) managers that EO employees should clearly explain in the case files the reasons why information items are selected for examination or for closure without an examination. The Director, EO Examinations will reiterate these instructions in a memorandum she will send to all Examination managers. The memorandum also will require EO employees to note within the files the dates information items are classified and the dates examinations begin. The memorandum will further reiterate the need to use accurate and specific source codes on the AIMS.

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IMPLEMENTATION DATE

January 31, 2001

RESPONSIBLE OFFICIAL(S)

Director, Exempt Organizations Examinations

CORRECTIVE ACTION MONITORING PLAN

A copy of the memorandum will be provided to the Director, Exempt Organizations.

IDENTITY OF RECOMMENDATIONS #3 and #4

Revise the Tax Exempt Quality Measurement System (TEQMS) Case Review Input Form to include elements for documenting the source of referrals on completed examinations.

Perform a mandatory review on all non-examined referrals and information items to provide further assurance that all of the appropriate approvals and written explanations are documented in the Examination case file.

ASSESSMENT OF CAUSE(S)

Files of cases selected for examination do not consistently contain enough information to document the source of the referral. Further, files of some cases closed without an examination do not show the Group Manager's approval of the decision to close without an examination, and the decision to survey the case is not always stamped across the face of the return.

The corrective actions TE/GE outlined below will result in us reviewing all information item cases when they are closed. These reviews will accomplish recommendations #3 and #4, although they will do so in a slightly different manner from that described.

CORRECTIVE ACTIONS

TE/GE will develop procedures requiring all information items, examined and unexamined, to close through EO's centralized classification unit in Dallas. Every information item will be reviewed before closure to ensure the history of the case is adequately documented. When an examined information item arrives for closure, the classification unit will review the examination file to ensure the referral sheet is present and that it has been properly prepared. A complete referral sheet will document the reason we selected the information item for examination, the source of the information item, and all relevant dates. The classification unit will ensure that the decision to survey the case is stamped across the face of the return. When an unexamined information item arrives for closure, the classification unit will review the file to ensure that a form 1900 has

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been properly prepared. A complete form 1900 will document the reason the item was closed without an examination (survey).

IMPLEMENTATION DATE

January 31, 2001

RESPONSIBLE OFFICIAL(S)

Director, Exempt Organizations Examinations

CORRECTIVE ACTION(S) MONITORING PLAN

A copy of the procedures will be provided to the Director, Exempt Organizations.

You may contact Mike Daly at (202) 622-6174 if you have any questions.